12

Prizes, Scholarships, Damages, Refunds, and Other Income

Almost everything that you earn, win, or even find must be reported as taxable income. You must report lottery and gambling winnings, prizes, and certain refunds of state and local taxes. However, the law allows several exceptions, such as the tax-free receipt of insurance proceeds, certain scholarship awards, and gifts and inheritances. Insurance, gifts, and inheritances are discussed in Chapter 11.

The tax on Social Security benefits is discussed in Chapter 34.

Jury duty pay is taxable, but if you have to turn it over to your employer in return for getting your regular salary, you may claim an offsetting deduction, even if you do not itemize deductions. Claim the deduction on Line 30 of Form 1040.

The types of income discussed in this chapter are reported as "other income" on Line 21 of Form 1040, except for taxable refunds of state and local taxes (¶12.7), which are reported on Line 10.

Prizes and Gambling Winnings

¶12.1 Prizes and Awards

Prizes and awards are taxable income except for an award or prize that meets *all* these four tests:

1. It is for outstanding educational activities, literary, or civic achievement.
2. You were selected without any action on your part.
3. You do not have to perform services.
4. You assign the prize or award to a government unit or tax-exempt charitable organization. You must make the assignment before you use or benefit from the award. You may *not* claim a charitable deduction for the assignment.

Prize taxed at fair market value. A prize of merchandise is taxable at fair market value. For example, where a prize of first-class steamship tickets was exchanged for tourist-class tickets for a winner's family, the taxable value of the prize was the price of the tourist tickets. What is the taxable fair market value of an automobile won as a prize? In one case, the Tax Court held that the taxable value was what the recipient could realize on an immediate resale of the car.

Employee achievement awards. The above restrictions on tax-free treatment do not apply to awards from employers for length of service or safety achievement. The rules for such employee awards are at ¶3.10 and ¶20.25.

¶12.2 Sweepstake and Lottery Winnings

Sweepstake, lottery, and raffle winnings are taxable as "other income" on Line 21 of Form 1040. The cost of tickets is deductible only to the extent you report winnings, and only if you itemize deductions. The deduction is claimed on Schedule A as a miscellaneous deduction that is *not* subject to the 2% adjusted gross income (AGI) floor (Chapter 19). For example, if you buy state lottery tickets and win a 1996 drawing, you may deduct the cost of your losing tickets in 1996 up to the amount of your winnings.

When a minor wins a state lottery and the prize is held by his or her parents as custodians under the Uniform Gifts to Minors Act, the prize is taxed to the minor in the year the prize is won.

CAUTION

Splitting Sweepstake Winnings

To split income, potential sweepstake winnings may be divided among family members or others before the prize is won. You might buy the sweepstakes or lottery ticket in your name and the names of others. The prize is shared and each portion separately taxed. However, the IRS has not allowed income splitting after the prize is won. In one case, a couple who bought a winning lottery ticket that under state law was payable to only one person proved they shared the ticket before the drawing by having their attorneys draw up a joint ownership agreement.

Installment payments. If winnings are payable in installments, you pay tax only as installments are received. This is true even if the payer is required by state law to buy a surety bond as security for future installments. That the payments are secured does not make them immediately taxable where you have no choice in the way payments are made. If you have the chance to elect a lump-sum payment but instead choose installments, you are in "constructive receipt," and thus are taxable on the entire amount in the year the prize is awarded.

¶12.3 Gambling Winnings and Losses

Gambling winnings are taxable. Losses from gambling are deductible only up to the gains from gambling. You may not deduct a net gambling loss even though a particular state says gambling is legal. Nor does it matter that your business is gambling. You may not deduct the loss even if you are a professional gambler.

If you are not a professional gambler, gambling income is included on Form 1040 as "other income" on Line 21. Gambling losses (not exceeding the amount of the gains) are deductible as "miscellaneous deductions" on Schedule A. The losses are *not* subject to the 2% AGI floor (Chapter 19). According to the IRS, professional gamblers who bet only for their own account are not in a business and must deduct losses (up to gains) as itemized deductions. However, the Supreme Court has held that full-time gamblers may deduct losses as business expenses even if they place wagers only for themselves. According to the Supreme Court, in order to be considered engaged in a business, a gambler must prove that he or she bets full time to earn a livelihood and not merely as a hobby.

To prove your losses in the event your return is questioned, you must retain evidence of losses.

EXAMPLES

1. To appear on the Wheel of Fortune, Whitten traveled from Chicago to Los Angeles, spending $1,820 for transportation, meals, and lodging. When he won cash prizes of $14,850 plus an automobile, he tried to offset his winnings by the travel costs, claiming they were gambling losses on Schedule A not subject to the 2% AGI floor. The IRS and Tax Court disagreed; travel costs are not like wager or bet losses.
2. Trump Casino in Atlantic City gave Libutti, a high roller at its gaming tables, over $2.5 million in "comps" during a three-year period in which he lost over $8 million. The comps included 10 expensive automobiles, jewelry, European vacations, and tickets to sporting events. Libutti reported the comps as income and then claimed a matching miscellaneous deduction for gambling losses not subject to the 2% floor. The IRS disallowed the deduction, claiming that the comps were not gambling income because they were perks given to stimulate his desire to gamble at Trump's, and not winnings from the success of his wagers.

   The Tax Court disagrees. Libutti would not have received the comps unless he gambled at high stakes in Trump's casino. Although the comps did not directly hinge on the success or failure of his wagers, the comps were sufficiently related to his gambling losses to allow the deduction.

Scholarships, Fellowships, and Grants

¶12.4 Scholarships and Grants

Scholarships and fellowships of a *degree candidate* are tax free to the extent that the grant pays for tuition and course-related fees, books, supplies, and equipment that are required for courses. Amounts for room, board, and incidental expenses are taxable. If you are not a candidate for a degree (*see* Degree test in the next column) your entire grant is taxable.

You must pay tax on grants or tuition reductions that pay for teaching or other services required as a condition of receiving the grant. This is true even if all degree candidates are required to perform the services. Thus, if you are a graduate student and receive a stipend for teaching, those payments are taxable, subject to withholding, and are reported by the school on Form W-2. Similarly, no tax-free exclusion is allowed for federal grants where the recipient agrees to do future work with the federal government.

Degree test. Scholarships given to students attending a primary or secondary school, or to those pursuing a degree at a college or university, meet the degree test. Also qualifying are full-time or part-time scholarships for study at an educational institution that (1) provides an educational program acceptable for full credit towards a higher degree or offers a program of training to prepare students for gainful employment in a recognized occupation; and (2) is authorized under federal or state law to provide such a program and is accredited by a nationally recognized accreditation agency.

¶12.5 Tuition Plans for College Employees

Free or partially free tuition for *undergraduate* studies provided to faculty members or school employees is generally not taxable. The tuition reduction may be for education at his or her own school or at another similar school. Tuition benefits may be taxable to highly compensated employees if the plan discriminates in their favor.

Tax-free tuition benefits may also be provided to the employee's spouse, dependent child, a former employee who retired or left on disability, a widow or widower of an individual who died while employed by the school, or a widow or widower of a retired or disabled employee.

A child under the age of 25 qualifies for tuition reduction if both parents have died and one of the parents qualified for tax-free tuition benefits. If the child is age 25 or over, tuition reductions are taxed even if both parents are deceased.

Tuition reduction for teaching and research assistants. If you must teach, do research, or provide other services to obtain a tuition reduction for *graduate or undergraduate* studies, a tuition reduction from the school is tax free if it is in addition to regular pay for the services. If the tuition reduction is your compensation, it is taxable.

¶12.6 How Fulbright Awards Are Taxed

Fulbright awards for teaching, lecturing, or research are taxable unless you can claim the foreign earned income exclusion to avoid tax on the grant (Chapter 36). If you do not qualify for the exclusion and if your overseas stay is temporary and you intend to return to your regular teaching position in the United States, you may deduct the cost of your travel, meals, and lodgings overseas.

Tax Refunds and Other Recovered Deductions

¶12.7 Refunds of State and Local Income Tax Deductions

A refund of state or local income tax is not taxable if you did not previously claim the tax as an itemized deduction in a prior year. For example, if you claimed the standard deduction on your 1995 return and in 1996 you received a refund for state tax withheld from your 1995 wages, the refund is not taxable.

If you did claim the refunded tax as an itemized deduction, the refund is taxable only to the extent that your itemized deductions exceeded the standard deduction you could have claimed in the prior year. If, in addition to the tax refund, you received recoveries of other itemized deductions, the same computation applies to determine the taxable portion of the total recovery; *see* ¶12.8.

To help you figure the taxable portion of 1995 itemized deductions recovered in 1996, 1995 standard deduction amounts are shown in the table at the end of this section.

The computation of the taxable refund is different if, in the year the refunded item was claimed, you were subject to the 3% reduction of itemized deductions. In this case, the IRS provides a special method explained in Publication 525.

EXAMPLE

On your 1995 return, you filed as a single taxpayer. You claimed itemized deductions of $4,300, of which $2,300 was for state and local taxes, $1,500 was for mortgage interest and $500 was for charitable contributions. Your deductions exceeded by $400 the $3,900 standard deduction you could have claimed. The deductions were not subject to the 3% reduction discussed at ¶13.8.

In 1996, you received from the state a $750 refund for 1995 state taxes. You must report $400 of the refund as income on your 1996 Form 1040. The taxable recovery is limited to the $400 difference between the itemized deductions claimed and the $3,900 standard deduction. If the refund were $400 or less, the entire refund would be taxable.

If you had a *negative* taxable income in 1995, the taxable recovery figured under the above rule is reduced by the negative amount. If you had a negative taxable income of $100 in 1995, only $300 of the refund would be taxable instead of $400.

Allocating a refund recovery. If in 1995 you received a refund of state or local taxes and also a recovery of other deductions, and only part of the total recovery is taxable, you allocate the taxable amount of the recovery according to the ratio between the state tax refund and the other recovery. You do this by first dividing the state refund by the total of all itemized deductions recovered. The resulting percentage is then applied to the taxable recovery to find the amount to report as the tax refund on Line 10 of Form 1040; other taxable recoveries are reported on Line 21.

EXAMPLE

In 1996, you received a refund of state income taxes of $500 and a recovery of other itemized expenses of $2,000 deducted in 1995. You figure that only $1,500 of the recovery is taxable because your total 1995 itemized deductions were $1,500 more than the standard deduction you could have claimed. As a state tax refund is reported separately from other recoveries, you must find how much of the taxable recovery is attributed to the refund. By dividing the state tax refund by the amount of the total recovery, you find that 20% is attributed to the refund ($500/$2,500). Thus, 20% of the taxable recovery, or $300 (20% of $1,500), is reported as a state refund on Line 10, Form 1040, and the balance of $1,200 on Line 21, Form 1040. Also attach a statement showing that the allocation of recoveries required the reporting on Line 10, Form 1040, of an amount less than the actual state refund shown on Form 1099-G.

Refund of state tax paid in installments over two tax years. If you pay estimated state or local income taxes, your last tax installment may be in the year you receive a refund. In this case, you allocate the refund between the two years; *see* the following Example.

EXAMPLE

Your estimated state income tax for 1995 was $4,000, which you paid in four equal installments. You made your fourth payment in January 1996. No state income tax was withheld during 1995. In 1996, you received a tax refund of $400. You claimed itemized deductions each year on your federal return. You allocate the $400 refund between 1995 and 1996. As you paid 75% ($3,000 ÷ $4,000) of the estimated tax in 1995, 75% of the $400 refund, or $300, is allocated to 1995. On your 1996 return, you include $300 as income on Line 10, Form 1040. You also attach a statement explaining that the amount on Line 10 is less than the $400 refund shown on the Form 1099-G received from the state because of the allocation required by the estimated tax payment in 1996.

When you figure your 1996 deduction for state income taxes, you reduce the $1,000 paid in January by $100. Your 1996 deduction for state income taxes will include the January net amount of $900 plus any estimated taxes paid in 1996 for 1996, any state income tax withheld during 1996, and any 1995 tax paid with your state income tax return filed in 1996.

Note: If the $300 refund allocated to 1995 in the previous Example was more than the excess of your 1995 itemized deductions over the 1995 standard deduction you could have claimed, you report only that excess as 1996 income. If in 1995 you were subject to the 3% reduction to itemized deductions, *see* IRS Publication 525 for figuring the taxable portion of the refund. Also *see* ¶12.8 for reducing the taxable amount if you had a negative taxable income, or if you recovered a bad debt or other non-itemized deduction.

1995 Standard Deduction for Figuring Recoveries of 1995 Itemized Deductions

If You Were—	*1995 Standard Deduction Was—*
Married filing jointly	$6,550
Single	3,900
Head of household	5,750
Married filing separately	3,275
Qualifying widow or widower	6,550
Single age 65 or over	4,850
Single and blind	4,850
Single age 65 or over and also blind	5,800
Married filing jointly with:	
One spouse age 65 or over	7,300
Both spouses age 65 or over	8,050
One spouse blind under age 65	7,300
Both spouses blind under age 65	8,050
One spouse age 65 or over and also blind	8,050
One spouse age 65 or over and other spouse blind and under age 65	8,050
One spouse age 65 or over and also blind; other spouse blind and under age 65	8,800
Both spouses age 65 or over and also blind	9,550
Qualifying widow or widower age 65 or over	7,300
Qualifying widow or widower and blind	7,300
Qualifying widow or widower age 65 or over and also blind	8,050
Head of household age 65 or over	6,700
Head of household and blind	6,700
Head of household age 65 or over and also blind	7,650
Married filing separately age 65 or over*	4,025
Married filing separately and blind*	4,025
Married filing separately age 65 or over and also blind*	4,775

* If you are claiming your spouse as an exemption (¶22.2), add $750 if he or she was either blind or age 65 or older; add $1,500 if he or she was both blind and age 65 or older.

¶12.8 Other Recovered Deductions

The income rule applied to refunds of state income tax in ¶12.7 applies also to the recovery of other items for which you claimed a tax deduction, such as a refund of adjustable rate mortgage interest (¶15.1), reimbursement of a deducted medical expense (¶17.5), a reimbursed casualty loss (¶18.1), a return of donated property which was claimed as a charitable deduction (¶14.1), and a payment of debt previously claimed as a bad debt (¶5.9).

EXAMPLE

In 1995, you filed a joint return and claimed itemized deductions of $8,000, which exceeded your standard deduction of $6,550. You were not subject to the 3% reduction to itemized deductions. In 1996, you received the following recoveries for amounts deducted in 1995:

Medical expenses	$200
State income tax refund	400
Interest expense	325
Total	$925

The total recovery of $925 is taxable. It is less than $1,450, the excess of your itemized deductions over the allowable standard deduction ($8,000 – 6,550). You report the state and local income tax refund of $400 on Line 10, Form 1040, and the balance of $525 on Line 21, Form 1040.

If the total recovery had been $2,500 instead of $925, $1,450 would be taxable (the excess of $8,000 over $6,550). The $1,050 balance would be tax free.

Negative taxable income. If your taxable income was a negative amount in the year in which the recovered item was deducted, you reduce the recovery includable in income by the negative amount. For example, if the taxable recovery is $1,700 but you had a negative taxable income of $500, only $1,200 is taxable.

Itemized and non-itemized deduction recoveries in one year. If you recover both itemized deductions and non-itemized deductions taken in the same year, follow this order:

1. Figure your non-itemized recovery;
2. Add the non-itemized recovery to taxable income; and
3. Figure your itemized recoveries based on the increased taxable income.

In figuring the recovery of a non-itemized deduction, such as a bad debt, the limitation effect of the standard deduction is ignored.

Tax credit in prior year. If you recover an item deducted in a prior year in which tax credits exceeded your tax, you refigure the prior year tax to determine if the recovery is taxable. Add the amount of the recovery to taxable income of the prior year and figure the tax on the increased taxable income. If your tax credit exceeds the recomputed tax, do not include the recovery in income. If the tax credit is less than the recomputed tax, include the recovery in income to the extent the recovery reduced your tax in the prior year.

Alternative minimum tax in the prior year. If you were subject to the alternative minimum tax (AMT) in the year the recovered deduction was claimed, recompute your regular and AMT tax for the prior year based on the taxable income you reported plus the recovered amount. If inclusion of the recovery does not change your total tax, you do not include the recovery in income. If your total tax increases by any amount, you include the recovery in income to the extent the deduction reduced your tax in the prior year.

Recovery of previously deducted items used to figure carryover. A deductible expense may not reduce your tax because you have an overall loss. If in a later year the expense is repaid or the obligation giving rise to the expense is cancelled, the deduction of that expense will be treated as having produced a tax reduction if it increased a carryover that has not expired by the beginning of the taxable year in which the forgiveness occurs. For example, you are on the accrual basis and deducted, but did not pay, rent in 1995. The rent obligation is forgiven in 1996. The 1995 rent deduction is treated as having produced a reduction in tax, even if it resulted in no tax savings in 1995 if it figured in the calculation of a net operating loss that has not expired or been used by the beginning of 1996, the year of forgiveness. The same rule applies to other carryovers such as the investment credit carryover.

Cancellation of Debts and Damage Awards

¶12.9 Cancellation of Debts You Owe

If your creditor cancels or reduces a debt you owe, you realize taxable income unless you can prove the creditor intended a gift or the cancellation qualifies for an exclusion. Exclusions are allowed for discharges of farm or business real estate debt and debts of insolvent and bankrupt persons, as explained below.

Form 1099-C. You should receive Form 1099-C from a federal government agency, credit union or bank that cancels or forgives a debt you owe of $600 or more. The IRS receives a copy of the form. Generally, the amount of canceled debt shown in Box 2 of Form 1099-C must be reported as "other income" on Line 21 of Form 1040, unless one of the exclusions discussed below applies.

Discounted mortgage repayment. A prepayment of a home mortgage at a discount is taxable. The income is reported on Line 21, Form 1040. The tax treatment of a foreclosure sale or voluntary conveyance to a creditor is discussed at ¶31.10.

EXAMPLE

A bank allows a homeowner to prepay a low-interest mortgage of $20,000 for $18,000. The discount of $2,000 is taxable as ordinary income.

Cancellation of student loans. A cancelled student loan is taxable income with this exception: If a loan by a government agency or a qualified hospital organization is cancelled because you worked for a period of time in certain geographical areas for certain types of employers, such as practicing medicine in rural areas or teaching in inner-city schools, then the cancelled amount is not taxable. The Tax Court held that a student loan cancelled by the State of Alaska was taxable. The Alaska law conditioned forgiveness only on working in Alaska and there was no requirement that work be in a special area for specified employers.

COURT DECISION: Gambler Not Taxed on Cancelled Gambling Debt

The federal appeals court for the Third Circuit (New Jersey, Pennsylvania, and Delaware) held that the settlement by an Atlantic City casino of a gambler's $3.4 million debt for $500,000 was not taxable. The debt was not enforceable under New Jersey law because the casino did not comply with state regulations on issuance of credit. Furthermore, the gambling chips were not "property" securing the debt; they had no economic value outside of the casino.

Debts discharged in bankruptcy. A discharge of a debt in a Title 11 bankruptcy case is not taxable, but is used to reduce specified "tax attributes" on Form 982 in this order:

1. Net operating losses and carryovers—dollar for dollar of debt discharge;
2. Carryovers of the general business credit—33⅓ cents for each dollar of debt discharge;
3. AMT minimum tax credit as of the beginning of the year immediately after the taxable year of the discharge—33⅓ cents for each dollar of debt discharge;
4. Net capital losses and carryovers—dollar for dollar of debt discharge;
5. Basis of depreciable and nondepreciable assets—dollar for dollar of debt discharge (but not below the amount of your total undischarged liabilities);
6. Passive activity loss and credit carryovers—dollar for dollar of debt discharge for passive losses; 33⅓ cents for each dollar of debt discharge in the case of passive credits; and
7. Foreign tax credit carryovers—33⅓ cents for each dollar of debt discharge.

After these reductions, any remaining balance of the debt discharge is disregarded. On Form 982, you may make a special election to first reduce the basis of any depreciable assets before reducing other tax attributes in the order above. Realty held for sale to customers may be treated as depreciable assets for purposes of the election. The election allows you to preserve your current deductions, such as a net operating loss carryover or capital loss carryover, for use in the following year. The election also will have the effect of reducing your depreciation deductions for years following the year of debt cancellation. If you later sell the depreciable property at a gain, the gain attributable to the basis reduction will be taxable as ordinary income under the depreciation recapture rules of ¶44.1.

Separate bankruptcy estate. If you are an individual debtor who files for bankruptcy under Chapter 7 or 11 of the Bankruptcy Code, a separate "estate" is created consisting of property that belonged to you before the filing date. This bankruptcy estate is a new taxable

entity, completely separate from you as a taxpayer. The estate is represented by a trustee who manages the estate for the benefit of any creditors. The estate earns its own income and incurs expenses. The trustee reports the estate's income or loss on a separate return (Form 1041). The creation of a separate bankruptcy estate also gives you a "fresh start"; with certain exceptions, wages you earn and property you acquire after the bankruptcy case has begun belong to you and do not become part of the bankruptcy estate.

A separate estate is not created for an individual who files for bankruptcy under Chapter 12.

In a Title 11 case, the tax attribute reductions are made to the attributes in the bankruptcy estate. Reductions are not made to attributes of an individual debtor that come into existence after the bankruptcy case begins or that are treated as exempt property under bankruptcy rules. Basis reduction does apply to property transferred by the bankruptcy estate to the individual.

Debts discharged while you are insolvent. If your debt is cancelled outside of bankruptcy while you are insolvent, the cancellation does not result in taxable income to the extent of the insolvency. Insolvency means that liabilities exceed the fair market value of your assets immediately before the discharge of the debt. The discharged debt is not taxed to the extent of your insolvency and is applied to the reduction of tax attributes on Form 982 in the same manner as to a bankrupt individual. If the cancelled debt exceeds the insolvency, any remaining balance is treated as if it were a debt cancellation of a solvent person and, thus, it is taxable unless it is a qualifying farming debt or business real estate debt as discussed later in this section.

The IRS approach to figuring insolvency upon a debt cancellation is shown in the Example below.

EXAMPLE

In 1992, Jones borrowed $1,000,000 from Chester and signed a note payable for that amount. Jones was not personally liable on the note, which was secured by an office building valued at $1,000,000 that he bought from Baker with the proceeds of Chester's loan. In 1996, when the value of the building declined to $800,000, Chester agreed to reduce the principal of the loan to $825,000. At the time, Jones held other assets valued at $100,000 and owed another person $50,000.

To determine the extent of Jones's insolvency, the IRS compares the value of Jones's assets and liabilities immediately before the discharge. According to the IRS, his assets total $900,000: the building valued at $800,000 plus other assets of $100,000. His liabilities total $1,025,000: the other debt of $50,000 plus the liability on the note, which the IRS considered to be $975,000, equal to the $800,000 value of the building and the discharged debt of $175,000. Jones is insolvent by $125,000 ($1,025,000 in liabilities *less* $900,000 in assets). As $175,000 was the amount of the discharged debt and Jones was insolvent to the extent of $125,000, only $50,000 is treated as taxable income.

Partnership debts. When a partnership's debt is discharged because of bankruptcy, insolvency, or if it is qualified farm debt or business real estate debt that is cancelled, the discharged amount is allocated among the partners. Bankruptcy or insolvency is tested not at the partnership level, but separately for each partner. Thus, a bankrupt or insolvent partner applies the allocated amount to reduce the specified tax attributes as previously discussed. A solvent partner may not take advantage of the rules applied to insolvent or bankrupt partners, even if the partnership is insolvent or bankrupt.

Purchase price adjustment for solvent debtors. If you buy property on credit and the seller reduces or cancels the debt arising out of the purchase, the reduction is generally treated as a purchase price adjustment (reducing your basis in the property). Since the reduction is not treated as a debt cancellation, you do not realize taxable income on the price adjustment. This favorable price adjustment rule applies only if you are solvent and not in bankruptcy, you have not transferred the property to a third party, and the seller has not transferred the debt to a third party, such as with the sale of your installment contract to a collection company.

Qualified farm debt. A solvent farmer may avoid tax from a discharge of indebtedness by an unrelated lender, including any federal, state, or local government agency, if the debt was incurred in farming or is a farm business debt secured by farmland or farm equipment used in the farming business. You are eligible for this relief only if 50% or more of your total gross receipts for the preceding three taxable years was derived from farming. The excluded amount first reduces tax attributes such as net operating loss carryovers and business tax credits. The excluded amount then reduces the farmer's basis in all property other than farmland, and then the basis in land used in the farming business.

Business real estate debt. A solvent taxpayer may elect to avoid tax on a discharge of qualifying real property business debt. Such a discharge may occur where the fair market value of the property securing the debt has fallen in value. This relief applies to debt discharges after 1992. The debt must have been incurred or assumed in connection with business real property and must be secured by such property. A debt incurred or assumed after 1992 must be incurred or assumed to buy, construct, or substantially improve real property used in a business, or to refinance such acquisition debt (up to the refinanced amount). Debt incurred after 1992 to refinance a pre-1993 business real property debt (up to the refinanced amount) also qualifies. The debt must be secured by the property. Discharges of farm indebtedness do not qualify but may be tax free under the separate rules discussed earlier.

The maximum amount that can be excluded from income is the excess of the outstanding loan principal (immediately before the discharge) over the fair market value (immediately before the discharge) of the real property securing the debt, less any other outstanding qualifying real property business debts secured by the property. The excludable amount also may not exceed the taxpayer's adjusted basis for all depreciable real property held before the discharge. The excluded amount reduces basis in all depreciable real property.

Effect of basis reduction on later disposition of property. A reduction of basis is treated as a depreciation deduction so that a profitable sale of the property at a later date may be subject to the rules of recapture of depreciation; *see* ¶44.1.

¶12.10 How Legal Damages Are Taxed

Awards recovered through legal action, whether fixed by a court or a settlement between the parties, are generally taxable, unless they qualify as compensation for a personal injury, such as damages awarded for a physical injury in an auto accident. Interest paid on a tax-free damage award is taxable.

When a payment compensates for loss of profits and goodwill or capital, make sure to have evidence for allocating the award between profits and goodwill or capital assets. Otherwise, the entire amount may be taxed as a recovery of profits. Be certain that your complaint is drawn so that it clearly demands a recovery both for loss of profits and injury to property. Seek to have any lump-sum award divided between the two in any judgment. If your action is settled, make sure the settlement agreement specifically earmarks the nature of the payments. To support a claim that goodwill was damaged, have evidence of the specific customers lost.

When damages compensate for the loss of property, you have taxable gain if the damages exceed adjusted basis of the property. A deductible loss will generally be allowed when the recovery is less than adjusted basis. The nature of the gain or loss takes on the same character (that is, capital gain or loss or ordinary income gain or loss) as the property lost.

Wrongful death awards. Compensatory damages received in a wrongful death action are a tax-free personal injury award. Under the new law, punitive damages are taxable unless they are the only damages that may be awarded under state law and the same state law treatment applied as of September 13, 1995.

Legal fees. If the damages are tax free, you may not deduct your litigation costs. If your damages are fully taxed, you deduct all of your litigation costs. If your damages are only partially taxed, then you deduct only that portion of your litigation costs attributed to the taxed damages.

When your attorney receives payment of taxable damages and then turns over the money after deducting his or her fee, you are taxed in the year you receive your share.

Legal fees that are deductible as miscellaneous expenses are subject to the 2% adjusted gross income floor; *see* Chapter 19.

LAW ALERT

Discrimination and Other Nonphysical Injury Awards Taxable

Under a new law, tax-free treatment for personal injury awards is limited to damages received on account of a physical injury or physical sickness. In such cases, all damages other than punitive damages are tax free, including awards for emotional distress attributable to a physical injury or physical sickness.

Damages received in discrimination or other nonphysical injury cases are taxable with one exception: Damages up to the amount of actual medical care expenses attributable to emotional distress are tax free. Apart from the medical care exception, emotional distress, including physical symptoms such as insomnia, headaches and stomach disorders, is not by itself considered a physical injury or sickness.

The new law takes effect for damages received after the date of enactment. *See* the "What's New" page in the front of this book for the enactment date. The new rules do not apply to amounts received under binding written agreements, court decrees, or mediation awards in effect on September 13, 1995.

Damage awards received before the effective date of the new law are subject to the Supreme Court's 1995 *Schleier* decision. Under *Schleier*, economic damages such as back pay are taxable in discrimination and other cases not involving physical injury. However, compensatory damages for pain and suffering or emotional distress could qualify for tax-free treatment under *Schleier*.

Punitive damages. The new law discussed in the earlier Law Alert subjects to tax punitive damages received after the enactment date. The damages are taxable even if related to a physical injury or physical sickness. However, under a limited exception, punitive damages may be tax free in a wrongful death action; *see* "Wrongful death awards" in the preceding column.

Even *before* the new law took effect, the IRS and most courts held punitive damages to be taxable, although the effect of a 1989 law has been disputed. The 1989 law specifically subjected to tax punitive damages (in cases filed after July 10, 1989) that do not involve physical injury, and some have inferred that where there is physical injury, tax-free treatment for punitive damages would be allowed. This issue, as well as the tax treatment of punitive damages before enactment of the 1989 law, is expected to be settled by the Supreme Court in a case that was under appeal when this book went to press.